Moody's Investors Service
Global Credit Research

Municipal Credit Research
Rating Update
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California (State of)

Contacts

Raymond Murphy	212-553-4673
Timothy Blake	212-553-0849
Renee Boicourt	212-553-7162

Moody's Rating

Moody's Lowers State of California GO Bond Rating to A2 from A1; Lease Debt Lowered to A3 from A2; Ratings on 2003 RANS and CP Affirmed

$27.4 Billion in Outstanding Debt Affected. Outlook Revised to Stable

Opinion

Moody's has lowered the rating on $21.9 billion of outstanding State of California General Obligation bonds to A2 (with a stable outlook) from A1, and assigns this rating to the state's upcoming $900 million general obligation bond sale. In addition, we have lowered the rating on $5.5 billion in lease revenue bonds from A2 to A3. These rating actions reflect the magnitude of the imbalance between the state's revenues and expenditures, and the expectation the state will not be able to sufficiently address the imbalance in the upcoming fiscal year - given the inherent obstacles to reaching consensus on solutions to the problem. Absent a stronger than anticipated state and national economic rebound this year, we expect deficits to persist beyond fiscal 2004. As a result, the state will likely rely on rollover financing in the short-term market to meets its cash flow needs over the next 18 months to two years.

TWO-YEAR DEFICIT ESTIMATED TO BE AT LEAST $26 BILLION; GOVERNOR SEEKS MAJOR CUTS AND TAX INCREASES

The governor's fiscal 2004 budget proposal released earlier this month seeks to address a structural deficit of $34.6 billion. The Legislative Analyst's Office (LAO) sizes the problem at approximately $8 billion less, due both to a slightly more optimistic revenue outlook and the conventions it uses towards projecting the spending baseline. The deficit reflects the severe fall-off in tax revenue collections due to the continued weak performance of the state and national economies and the weak stock market. The deficit is also driven by increased spending pressures attributable primarily to rising health care costs. Even by the LAO's accounting, the size of the deficit is larger as a percentage of the annual budget (nearly 23%) than any shortfall in California history, and among the largest of the U.S. states. Dramatic budget actions will be required to restore structural budget balance.

The governor's budget proposal indeed seeks such dramatic actions, including expenditure reductions, cost savings, and state-local program realignment to be funded with dedicated tax increases. If adopted as proposed, these and other actions would eliminate a significant portion of the state's budget imbalance on an ongoing basis, greatly reduce its historic dependence on highly volatile revenues, and significantly improve its liquidity position. The major proposals include increasing taxes by more than $8.3 billion; and eliminating the state's motor vehicle license fee (MVLF) backfill to cities and counties at a loss of $4 billion in revenue for local governments in the current and budget years combined. In addition, the governor's proposal would cut $4 billion in Medicaid, which the LAO has indicated would entail dropping 560,000 ineligible Medi-Cal recipients from the rolls, cutting provider payments, and rollback expansions of coverage to the working poor and aged and disabled. The proposal also includes a broad array of cuts to most areas of state government spending.

The California state constitutional requirement of a two-thirds majority vote of the legislature to enact a budget will make reaching political consensus difficult. Both the expenditure and revenue proposals are expected to encounter strong opposition from various constituencies, as evidenced by the legislature's current strong opposition to the proposal to eliminate the MVLF backfill. Given the magnitude of the budget problem, the obstacles to crafting a solution that solves the problem by the end of the 2004 fiscal year are daunting. As a result, we see a strong possibility that cash stringency and reliance on the short-term markets for liquidity will persist beyond the end of fiscal 2004.

MIG1 AND MIG2 NOTE RATINGS AFFIRMED

The proposed budget includes certain expenditure reductions and cost savings that are projected to reduce the state's current year shortfall by approximately $4 billion, including $1.2 billion from the elimination of the backfill, and $2.8 billion of spending reductions. Legislative action will be necessary by June to achieve the 2003 financial targets. As previously indicated, the legislature has rejected the backfill proposal, but has reached agreement on approximately $3.2 billion in spending cuts. However, the expenditure reduction legislation also includes an MVLF increase - a proposal the governor does not support. Because of the link between the expenditure reductions and the fee increase, the governor has indicated he will veto the legislation.

Despite the likely veto, Moody's anticipates the legislature will adopt various expenditure reductions, but the current year savings to be realized are likely to be lower than the governor's proposed targets. As a result, the state's cash position at June 30, 2003 will be less than the $1.57 billion balance projected by the governor. Due to the state's tight cash position, we see a high likelihood that the state will need to issue revenue anticipation warrants before the end of the current fiscal year.

Moody's expects the state to need to size the anticipated RAWs to fully retire any maturing 2003 RANs for which sufficient cash is not available, and to cover its cash flow needs through the first quarter of fiscal 2004 should adoption of the fiscal 2004 budget be delayed as expected. We anticipate the state will successfully place its revenue anticipation warrants for such purposes. In addition, we expect that sufficient current year budget adjustments will be made to allow the state to retire the $9.5 billion notes maturing June 20, 2003 with available cash from operations. In the case of the notes maturing June 27th, we expect the state will rely on RAW proceeds to retire at least some portion of these notes. Based on these expectations, Moody's affirms its MIG1 and MIG2 ratings on the state's 2003 RANs.

P-1 RATING ON CP AFFIRMED

At this time, Moody's also affirms its P-1 rating on the state's Commercial Paper Program, reflecting the state's ability to issue long-term bonds to take out the outstanding paper prior to maturity, the additional liquidity for the maturing paper provided by a standby purchase agreement (SNPA) provided by a group of highly-rated banks, and satisfactory legal provisions which ensure timely access to the SNPA.

Outlook

Moody's credit outlook for California's long-term debt is revised to stable at the A2 rating. Despite the negative affect the under-performance of the high technology continues to have on the Bay Area economy, the state's significant economic diversity should enable the state economy to keep pace with the nation over the near term. We anticipate the legislature will take various actions during the current legislative session to reduce the size of the current shortfall, but - given the size of the projected structural deficit - not fully solve the problem within the 2004 fiscal year. As a result, the state will need to continue to rely heavily on the short-term market to meet its cash flow needs at least through fiscal 2004. However, while reliance on the short-term market presents a measure of market confidence risk, Moody's expects the state to successfully access the short-term market in the near term. Additionally, the stable outlook is predicated on the expectation of positive, albeit moderate, state economic growth by the end of the current calendar year. Any further deterioration in the state and national economies, or the legislature's inability to make sufficient progress in addressing the state's structural imbalance during the current legislative session, will necessarily place further negative pressure on the state's current rating and outlook.